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IN THE

Supreme Court of the United States

October Term, 1977

No. 77-1279

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH and FLESCHNER BECKER ASSOCIATES,

Petitioners,

v.

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONERS' REPLY BRIEF

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Petitioners Malcolm K. Fleschner, William J. Becker, Harold B. Ehrlich and Fleschner Becker Associates submit this brief in reply to the Brief for Respondents in Opposition submitted on behalf of respondents Robert and Marjorie Abrahamson.[1]

The implication of a private right of action for damages under the Investment Advisers Act of 1940, only after almost 40 years' experience with a statute of extremely limited length, scope and objectives, is hardly "inevitable," as respondents claim (Br. 8). The entire court below found there to be no claim stated under Section 10(b) of the Securities Exchange Act of 1934, but the majority avoided the implications of this conclusion by holding that the same allegations did state a claim for relief under a novel implied right of action under the Advisers Act.

[1] References to the brief filed by respondents are indicated by the designation "Br." preceding a page citation.

I.

The question of whether a private action for damages may be implied under the Advisers Act is one that has deeply divided the federal courts. The three Courts of Appeals to have implied such a right of action have done so only over strenuous dissenting opinions and after reversing the District Courts below.[2]

The court below improperly formulated a legislative issue with respect to the Advisers Act: "whether there should be a private right of action to recover damages" (A27). Directly contrary to the legislative history and the admittedly limited regulatory scheme imposed by the Act, respondents and the majority below alike have imputed to the 1940 legislation "broad remedial purposes" on imagined congressional findings of widespread abuses by investment advisers. On these hypotheses—both false—the implication of a private right of action for damages is characterized as a fulfillment of unexpressed congressional intent, rather than naked judicial usurpation of a wholly legislative function.

In *Cort* v. *Ash*, 422 U.S. 66 (1975), this Court articulated four factors to instruct and guide the lower courts in determining whether a private right of action may be implied in a federal statute where such a private right is not expressly provided for. By fundamentally misconstruing the purposes behind the Advisers Act, respondents and the majority below have given a wholly inadequate analysis of these *four* criteria. *Cort* is turned on its head by respondents' conclusion (*e.g.*, Br. 14, 16) that private rights of action for damages should be implied unless Congress clearly and convincingly expressed its intent to withhold or limit such rights. Judge Timber's statement—that he "hesitate[d] to reach such a result absent clear evidence from the Act's legislative history that private actions were not intended" (A23)—is nothing short of a manifest refusal to give a balanced consideration to the four factors, which we treat herein beginning with those factors that the court below brushed aside in order to create such private damage actions in the face of affirmative evidence of Congress' contrary intent.

[2] See opinions below and *Wilson* v. *First Houston Investment Corp.*, 566 F.2d 1235 (5th Cir., Feb. 2, 1978).

On April 19, 1978 the Court of Appeals for the Ninth Circuit in *Lewis* v. *Transamerica Corp.*, reversing the District Court (2-1; Wallace, J. dissenting), implied a private right of action. Neither the majority nor dissenting opinions independently analyzed the underlying issues, but rather merely adopted the arguments made in the majority and dissenting opinions of the Second Circuit in this case. We have been advised that appellees intend to file by May 5, 1978 a petition for a writ of certiorari to review the Ninth Circuit's order, with a motion to expedite consideration of the petition so that these two cases may be treated together.

A. "The Underlying Purposes of the Legislative Scheme."

Unlike other securities laws the 1940 Advisers Act was not promulgated on the strength of any finding of pervasive abuses—among investment advisers or otherwise. To the contrary, the legislative history shows that it was the absence of adequate information about advisers that was the principal focus of the Act. A "compulsory census" through registration was sought as the "basic approach" of the Act to make possible an "intelligent . . . appraisal of the economic function or the abuses which *might* exist" (testimony of David Schenker for the SEC in the Senate Hearings) (emphasis added).[3]

[3] *Hearings on S. 3580 before the Subcomm. of the Senate Comm. on Banking & Currency*, 76th Cong., 3d Sess. 48 (1940). *See also* S. Rep. No. 1760, 86th Cong., 2d Sess., U.S. Code Cong. & Adm. News 3502 (1960).

With recognition of its general ignorance of the so-called investment advisers industry, then in its infancy, Congress did not presume to know the ills of the industry, and it accordingly did not prescribe an elaborate regulatory scheme with extensive administrative and judicial controls as a cure. The Act did not have "broad remedial purposes." We submit, contrary to respondents' suggestion, that it is no accident that "the Advisers Act is a less complex, less pervasive regulatory enactment than the Exchange Act" (Br. 14), and likewise no accident that the latter has numerous expressly stated rights of action for damages and the former none at all.

The assertion of the majority below (A23) that the denial of a private right of action for damages would "effectively frustrate" the underlying congressional purpose is simply untenable in light of the Act's informational goals through registration. *See also* Br. 17. Moreover, although the Advisers Act was enacted almost forty years ago, only within the last few years has there been any attempt on the part of plaintiffs to have a private right of action for damages implied under any section of the Act. This is because the other federal securities laws and state laws have afforded ample relief to injured parties suffering actual out-of-pocket damages.

Indeed, to imply an open-ended private right of action for damages under the Advisers Act would conflict with a fundamental congressional purpose in the federal securities laws, which were enacted to afford relief to persons who were defrauded in the purchase or sale of securities. *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975). As Judge Gurfein noted in dissent, to accord a private right of action for damages under the Advisers Act, especially to persons who have reaped huge profits and have neither bought nor sold any securities, is to

give such persons "*carte blanche* to convert themselves from victims to defrauders" (A45).

B. "Indication of Legislative Intent"

It is claimed that Congress was completely silent on the question of private rights of action under the Act (Br. 13-14; A25-26). Respondents argue that "Congressional intent to withhold private rights" cannot be inferred from "the absence of expressly created private rights (and a jurisdictional section referring to actions at law to enforce them)" (Br 14). Such reasoning is a complete inversion of the proper inquiry required by *Cort* as to whether there is evidence of an intent affirmatively to legislate a new federal claim.[4]

Furthermore, rarely has congressional intent to deny a private right of action been clearer from the legislative history. First, the Advisers Act, alone of all the federal securities statutes, nowhere contains any section expressly providing a civil action for damages. Second, the Act's jurisdiction section (Section 214), similarly unique in federal securities law, confers upon the district courts jurisdiction only of "violations" and "suits in equity to enjoin any violation." Respondents concede that the language of § 214 is "not quite the same as" the jurisdictional sections in all the other federal securities acts (Br. 10-11), but dismiss the affirmative deletion of the phrase "actions at law" from the jurisdictional grant of § 214 with an appeal to the absence of any express right—a *non sequitur* made even less persuasive by the fact that none of the

[4] This Court has repeatedly affirmed the principle of legislative construction that "when a statute limits a thing to be done in a particular mode, it includes the negative of any other mode", *Botany Mills* v. *United States,* 278 U.S. 282, 289 (1929). *See also National Railroad Passenger Corp.* v. *National Ass'n of Railroad Passengers,* 414 U.S. 453, 458 (1974), and *Securities Investor Protection Corp.* v. *Barbour,* 421 U.S. 412, 419 (1975).

drafts of the Advisers Act had any express provision for a right of action. The striking of the jurisdictional phrase "actions at law" from the original SEC drafts after industry participation must accordingly be accounted for on its own terms.[5] Third, Congress has had since 1940 three opportunities to include a provision for civil liability under the Advisers Act and each time Congress has failed to include such a provision. Respondents completely ignore this subsequent legislative history and instead rely on a passage in the Senate Committee Report concerning the Investment Company Act and the Investment Advisers Act that the Advisers Act " 'contains provisions generally comparable to those of' the Investment Company Act" (Br. 12 n.), which completely begs the question. *See* A38 n. 6.

C. The Alleged "Cause of Action is One Traditionally Relegated to State Law, in an Area Basically the Concern of the States."

Respondents prove the point made in our petition (Pet. 7-8) that the delineation of the cause's parameters would continue to trouble the courts, and invade the traditional province of state law. They would have the new right of action subsume the entire law of trusts, in derogation of actions "traditionally relegated to state law, in an area basically the concern of the States" (*Cort* v. *Ash*, 422 U.S. at 78):

> "Section 206 of the Advisers Act was intended to protect the integrity, not merely of an event such as a purchase or sale, but of a *relationship*. That relationship, moreover, is a *fiduciary* relationship. It is for this reason, we submit, that Section 206 prohibits *all* fraud practiced by an adviser upon his client, and not merely frauds practiced in connection with the purchase or sale of a security." (Br. 27) (footnotes and citation omitted) (emphasis in original)

[5] As an afterthought, respondents try to avoid the clear implication of the deletion of the "actions at law" language by emphasizing the use of the word "violations" in Section 214. Even the majority was unprepared to give any weight to this section (A26 n. 22) and Judge Gurfein in his dissent correctly pointed out that " 'violations' in the context means criminal violations, and violations on the civil side are limited to suits in equity" (A36 n. 4). Respondents' argument also ignores the fact that each of the other five securities laws expressly confirm jurisdiction on both "violations" and "actions at law".

There could not be a clearer expression of the hazards inherent in the majority's legislation of an unbounded new cause of action.

D. There was no Single Class for Whose "*Especial* Benefit" the Statute was Enacted.

In light of these three factors, wholly ignored in the majority opinion, it is clear that the Advisers Act singled out no one class of persons for *especial* benefit. The Act's modest informational objectives and the failure of the legislative history to support any findings of pervasive industry abuses is inconsistent with judicial designation of any such beneficiaries.

Indeed, it is ignored, in the legislative history cited by the majority itself, that the Act was not just for the benefit of clients of unscrupulous investment advisers, but "to safeguard the honest investment adviser against the stigma of the activities of these individuals" (A22 n. 18). Such a goal is completely consistent with enforcement of the Act only by suits in equity by the Commission.

II.

The tension between the assertions of law and the claims for money damages made by respondents is nowhere more evident than on the question of whether the individual petitioners here were "investment advisers." As a predicate to the applicability of the Advisers Act, respondents claim that

the petitioners were their advisers; but the wrong alleged, on the other hand, is that the general partners did not advise respondents on any of the investments made by them. As general partners of the partnership, they had broad discretionary authority under the partnership agreement, with exclusive powers of management of the partnership's assets as a matter of state law (*see* A34 n. 1). Respondents ignore the facts that the partnership agreement made no provision for the rendering of any advice based on the individual needs or preferences of any limited partner, and that the assets of the partnership were pooled for all purposes, including investment.[6]

Likewise, respondents have wrongly leaped from the fact that the individual petitioners engaged in the business of investment to the very different conclusion that they *advised others* on investments and were thus "investment advisers" under the Act.[7] The original conclusion of the majority

[6] As noted by Judge Gurfein (A45-46): "In this very case the [respondents] received profits from the restricted letter stock and waited almost a full year until the market became unfavorable before seeking redemption of their shares. They deliberately entered into a partnership that was going to operate in the most speculative of investment activities. They gave the general partners the power to invest in any kind of security, to sell short and cover both securities and commodities, to buy and sell options and to cover, to play the commodities market, to buy on margin, to lend money to partners without security, and to pledge partnership assets for loans. * * * Even a babe in the woods would know that he was giving his money to the general partners for discretionary speculation. The purchase of unregistered stock, far from being unforeseeable, fits quite well into this plan. * * * Given the purposes of the hedge fund and the broad powers vested in the general partners, it is hardly likely that the plaintiffs were interested in evaluating the portfolio themselves. Indeed, the plaintiffs never asked for a list of the securities held by the partnership."

[7] Respondents cite Brewer-Burner & Associates, Inc., [1973-1974 Transfer Binder] Fed. Sec. Rep. (CCH) ¶ 79,719 (1974), and imply that it is a "recent ruling" of the full Commission (Br. 23). To the contrary, it is a staff no-action letter, unlike the formal *contra* rulings of the full Commission cited by petitioners (Pet. Br. 18 n. 21).

below, that the individual petitioners advised the limited partners, was implicitly repudiated in its subsequent order on the petitions for rehearing, which withdrew the conclusion that the general partners as individuals were "investment advisers *to the limited partners*" (A51). The inference thus left—that they were only "investment advisers" to the partnership itself—is also unsustainable, since as the general partners of the partnership they had legal title to its assets, sole power to manage the partnership (as well as very substantial personal interests in the partnership and ever greater interests as trustees for their families), and would accordingly have to be found to be investment advisers to themselves, a result surely not contemplated by the statute.[8]

CONCLUSION

Under the Second Circuit's opinion respondents would be allowed to prosecute under the Advisers Act a claim for money damages based solely on their own assertions of their personal investment preferences and what they "would have done," although they in fact obtained a 48% return on their investment. These same allegations were held not to state a claim for relief under Section 10(b) of the Securities Exchange Act, in reliance on *Blue Chip Stamp* v. *Manor Drug*

[8] Respondents also endorse the majority's conclusion that brief monthly reports issued by the partnership were "reports which provided investment advice to the limited partners" (A15; *see* Br. 19-20). Yet it is conceded that the reports made no reference to any particular security, or the advisability of investing in securities, and were only "concise, two paragraph statements which set forth the percentage increase or decrease in value of the firm's investments for the year to date and compared the investments with Standard & Poor's "500 Stock Average" (A8). A document giving a single figure for the net performance of dozens of securities and other investments hardly constitutes investment advice.

Stores, 421 U.S. 723, 737-38 (1975). The potential for abuse in this alleged new cause is thus made clear in this very case.

For the reasons set forth in the petition and this reply brief, a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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